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When is a Note Security

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WHEN IS A NOTE A SECURITY?

INTRODUCTION

The issuing of a promissory note is a common event today.[1] Everyone from the largest corporation to the individual consumer participates in the making, issuing, or holding of promissory notes. During the last few years an increasing number of cases alleging security fraud violations have involved the issuance of promissory notes.[2] In order for the federal securities laws to apply, the notes must be securities. Without such a finding a court lacks subject matter jurisdiction and the antifraud provisions contained in the Securities Act of 1933[3] (1933 Act) and the Securities Exchange Act of 1934[4] (1934 Act) cannot be applied.[5]

The case law indicates that only some promissory notes are securities, and the test used in determining which notes are securities has changed radically in the last few years. The original test, commonly called the literal approach, involved a strict construction of the definition of security contained in the 1933 and 1934 Acts.[6] From a close reading of the statute the courts concluded that under the 1933 Act all promissory notes were securities,[7] while under the 1934 Act only notes having an original maturity in excess of nine months were securities.[8]

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1. For an historical account of the commercial paper market, see N. BAXTER, THE COMMERCIAL PAPER MARKET (2d ed. 1966); Johnston, *Rebirth of Commercial Paper,* 1968 MONTHLY REV. FED. RES. BANK S.F. For a thoughtful discussion of the present commercial paper market, see Comment, *The Commercial Paper Market and the Securities Act*, 39 U. CHI. L. REV. 362 (1972).

2. Since 1972, an increasing number of cases have discussed whether a promissory note is a security. A good number of these cases were brought in the Fifth Circuit. *See* McClure v. First Nat'l Bank, 497 F.2d 490 (5th Cir. 1974); Bellah v. First Nat'l Bank, 495 F.2d 1109, 1110 (5th Cir. 1974).

3. 15 U.S.C. §§ 77a-77bbbb (1970).

4. 15 U.S.C. §§ 78a-78jj (1970).

5. Securities Act of 1933, 15 U.S.C. § 77 (1970); Securities Exchange Act of 1934, 15 U.S.C. § 78 (1970). A security must be involved before the courts can obtain jurisdiction over the subject matter in an action under the 1933 or 1934 Act. A number of the cases involve dismissals before trial on the grounds that the court does not have jurisdiction to hear the case. *See* Bellah v. First Nat'l Bank 495 F.2d 1109, 1116 (5th Cir. 1974).

6. *See,* Llanos v. United States, 206 F.2d 852 (9th Cir. 1953).

7. The Securities Act of 1933, 15 U.S.C. § 77b(1) (1970), reads as follows: "When used in this subchapter, unless the context otherwise requires—(1) The term security means any note . . . ."

8. The Securities Exchange Act of 1934, 15 U.S.C. § 78c(a)(10) (1970), reads as follows: "When used in this chapter, unless the context otherwise requires— . . . (10)

In 1972, this literal approach began to lose favor in the courts.[9] Using the phrase "unless the context otherwise requires," which precedes the language defining the term "security" in both the 1933 and 1934 Acts, courts have avoided the literal wording of the statutes.[10] As a result of this departure, three tests have evolved for determining if a note is a security.

Generally, with the exception of two circuits, the courts facing this issue have adopted the commercial-investment note test.[11] This test makes a distinction between a note issued in an investment transaction and one issued in a commercial transaction with only the former recognized as a security. On the other hand, the Second Circuit, frustrated with the difficulty in discerning objective criteria for determining what is a security, has set out an exclusive list of transactions which remove a note from the ambit of securities laws.[12] In all other cases it simply returns to the literal approach. Finally, the Ninth Circuit has developed a test that emphasizes the importance of risk and sees this as the determining factor.[13]

This comment will examine the various approaches utilized by the courts in resolving the question of when a note becomes a security. Initially, it will discuss the literal approach, its statutory underpinnings, its application in early cases, and its ultimate rejection. Following this discussion, the focus will shift to an analysis of the three tests outlined above, which have emerged in the wake of the demise of the literal approach. Finally, it will assess the efficacy of these new tests and suggest how they might be harmonized to produce more consistent results.

THE LITERAL APPROACH

Both the 1933 and 1934 Acts require a transaction involv-

The term 'security' means any note, . . . but shall not include . . . any note . . . which has a maturity at the time of issuance not exceeding nine months. . . ."

9. Movielab, Inc. v. Berkey Photo, Inc., 452 F.2d 662 (2d Cir. 1971), is the last circuit decision which can be construed as applying the literal approach. Sanders v. John Nuveen & Co., 463 F.2d 1075 (7th Cir. 1972), applied the commercial-investment note test, is presently used in a majority of circuits.

10. *See* Lino v. City Investing Co., 487 F.2d 689, 694-95 (3d Cir. 1973).

11. For a case applying an analogous "investment" analysis, see SEC v. World Radio Mission, Inc., [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95751 (1st Cir. 1976).

12. *See* Exchange Nat'l Bank of Chicago v. Touche Ross & Co., [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95614 (2d Cir. 1976).

13. *See* Great W. Bank & Trust v. Kotz, 532 F.2d 1252 (9th Cir. 1976).

ing a security before federal subject matter jurisdiction attaches.[14] Thus, if a note was issued to an investor as part of a scheme to defraud, the first hurdle to a successful cause of action under the federal securities laws would be to show that the note was, in fact, a security.

For many years the courts took a literal approach in determining which promissory notes were securities. Using this test, the courts read the wording of the statutes very closely and concluded that all notes were securities under the 1933 Act while only notes with original maturity exceeding nine months were securities under the 1934 Act. A look at the statutory wording of these two Acts is required to understand the rationale of these early decisions.

The 1933 Act

Section 2(1) of the 1933 Act states that "unless the context otherwise requires—(1) The term 'security' means any note . . . ."[15] Read literally, this language includes all promissory notes within the term security. A later section of the Act exempts notes having an original maturity under nine months (short-term notes) from the registration provisions of the Act, but that section deals only with the filing requirements of the Act and does not redefine the term security to exclude short-term notes.[16] Since the anti-fraud provisions of the 1933 Act expressly apply to all securities, both long-term and short-term notes would seem to be protected. Indeed, under the literal approach, all promissory notes are covered by section 12(2)[17] which creates a private cause of action for those securities sold on the basis of false or misleading prospectuses or oral communications. Also, all securities are literally included under the protection of Section 17,[18] which uses language similar to that contained in rule 10b-5.[19]

14. A federal court has subject matter jurisdiction under Rule 10b-5 only if the fraud is in connection with the purchase or sale of a security. *See* Movielab, Inc. v. Berkey Photo, Inc., 452 F.2d 662, 663 (2d Cir. 1971). For a court to have jurisdiction under § 12(2) or § 17(a), the fraud must be in connection with an offer or sale of a security. 15 U.S.C. §§ 77*l*(2), 77q(a) (1970).

15. 15 U.S.C. § 77b(1) (1970).

16. "Except as hereinafter expressly provided, the provisions of this subchapter shall not apply to any of the following classes of securities:. . . (3) Any note . . . which arises out of a current transaction or the proceeds of which have been or are to be used for current transactions, and which has a maturity at the time of issuance of not exceeding nine months . . . ." 15 U.S.C. § 77c(a)(3) (1970).

17. 15 U.S.C. § 77*l* (2) (1970).

18. 15 U.S.C. § 77q (1970).

19. It is not clear if a private right of action is available under § 17(a), although

The 1934 Act

The Securities Act of 1934 states that "unless the context otherwise requires— . . . (10) The term security means any note . . . but shall not include . . . any note . . . which has a maturity at the time of issuance of not exceeding nine months. . . ."[20] Again, read literally, the 1934 Act defines security as any note except those having at issuance a maturity date of nine months or less.[21] Therefore, under the literal approach all short-term notes are excluded from the definition of security in the 1934 Act.

Section 10 of the 1934 Act and rule 10b-5 are both keyed to the term security. To bring an action under this section the alleged transaction must be in connection with the purchase or sale of a security.[22] Since short-term notes would be excluded from the definition of security under the literal approach, transactions involving short-term notes would not be protected by the anti-fraud provisions of this Act.

In summary, under a literal interpretation of the 1933 Act, all promissory notes are included within the definition of security. Therefore both long-term and short-term notes would be considered securities under the 1933 Act and would be subject to the anti-fraud provisions of that Act. On the other hand, a literal reading of the 1934 Act indicates that only long-term notes are included within the definition of security. Since a security must be involved to provide subject matter jurisdiction, the foregoing interpretation of the 1934 Act would exclude all short-term notes (notes which are not securities) from the application of its anti-fraud provisions, including rule 10b-5.

The Literal Approach Applied

Perhaps the leading case analyzing the note-security issue based on a literal reading of the Acts is *Llanos v. United States,*[23] a criminal case which arose under section 17(a)(1) of

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a majority of the few cases on the subject have held such a private right exists. The Supreme Court in *Blue Chip Stamps v. Manor Drug Stores* reserved this question in a footnote. 421 U.S. 723, 733 n.6 (1975). *See* Goldstein v. Grayson, [1969-1970 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 92645 (S.D.N.Y. 1970); Pfeffer v. Cressaty, 223 F. Supp. 756 (S.D.N.Y. 1963); *see generally* 3 L. LOSS, SECURITIES REGULATION 1784-89 (2d ed. 1961). *But see* Dyer v. Eastern Trust & Banking Co., 336 F. Supp. 890 (M.D. Me. 1971)(private right of action denied).

20. 15 U.S.C. § 78c(a)(10) (1970).

21. *Id.*

22. *See* Movielab, Inc. v. Berkey Photo, Inc., 452 F.2d 662, 663 (2d Cir. 1971).

23. 206 F.2d 852 (9th Cir. 1953).

the 1933 Act. In this case, Llanos and his cohorts were employing various false representations to obtain money for their own use. For example, to secure the funds they would tell the individuals that the money lent would be bet on a fixed football game. Induced by such representations, the individuals would part with money in return for ninety-day promissory notes.

Llanos and his cronies contended that they were not engaged in the sale of securities within the meaning of the 1933 Act, thus it did not apply. The appellate court disagreed. After quoting section 2(1) of the Act, which defines the term security, the court went on to state: "In defining the word security in Section 2(1) of the Act, Congress intended to include all interstate transactions which were the legitimate subject of its regulation and the section should not be construed narrowly."[24] It should be remembered that section 2(1) of the 1933 Act includes all notes of whatever maturity within the term security. Therefore, applying the literal approach, these notes amounted to securities under the 1933 Act.

In line with *Llanos,* most of the pre-1972 cases facing the question of whether the issuance of a note was subject to the protections of federal securities laws opted for this literal approach. These early cases typically interpreted the 1933 Act to include all notes within the meaning of "security" and the 1934 Act to include all long-term notes within that definition.[25] However, this literal approach proved too inflexible and often generated incomprehensible results depending on whether a long-term or short-term note was involved. As a result, courts began to cast about for a mode of interpreting the language of the Acts that would better serve their intended purposes.[26]

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24. *Id.* at 854.

25. In many of these cases, the courts did not even reach the note-security issue. Instead they simply assumed that the note is a security. *See* Titan Group, Inc. v. Faggen, 513 F.2d 234 (2d Cir. 1975); United States v. Smallwood, 443 F.2d 535 (8th Cir. 1971).

26. Movielab, Inc. v. Berkey Photo, Inc., 452 F.2d 662 (2d Cir. 1971), was perhaps the last major circuit decision in support of this literal approach. A very cautious decision, it failed to state whether all long-term notes were securities under the 1934 Act. The case involved the sale of certain corporate assets by the defendant to Movielab for two promissory notes. The notes totalled over $10,000,000 and were payable over 20 years. Movielab filed a complaint alleging that Berkey had made material misrepresentations in issuing its notes. Berkey moved for dismissal of the case, arguing that the issuance of the notes was not the sale of a security under the 1934 Act, and therefore, the federal court did not have subject matter jurisdiction.

The district court very reluctantly concluded that the 1934 Act did not grant the courts any discretionary power to construe the term security as including only certain types of long-term notes and assumed jurisdiction. On appeal the Second Circuit

THE MODERN APPROACHES

In turning away from the literal approach and opting for a new methodology for resolving the note-security issue, the courts looked to the security definitional sections in both the 1933 and 1934 Acts, which begin with the phrase "unless the context otherwise requires—". With the help of this phrase, a number of courts have concluded that not all notes are securities under the 1933 Act.[27] Further, this phrase has been used to avoid the long-term/short-term distinction which exists in the 1934 Act.[28]

Lino v. City Investing Co.[29] serves as an excellent example of this modern trend. In this case Lino purchased two franchise licenses from a subsidiary of City Investing. Payment was made in cash accompanied by several long-term promissory notes. Subsequent to this purchase, Lino brought an action under section 10b, rule 10b-5, of the 1934 Act, alleging that City Investing's material misstatements induced him to issue the promissory notes. In deciding that the long-term notes—which the literal approach treats as a security—issued by Lino were not securities within the meaning of the 1934 Act, the court stated: "All of the definitional sections involved in this case are introduced by the phrase 'unless the context otherwise requires—'. The commercial context of this case requires

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affirmed the district court by stating:

> [T]he definition of security in section 3(a)(10) of the [1934] Act states that "The term 'security' means any note . . ." and therefore includes some notes at the very least. Clearly then, notes issued by one publicly owned company to another publicly owned company for $10,500,000 payable over a period of 20 years, in exchange for the assets of the latter easily fall within the purview of the [1934] Act . . . .

Id. at 663.

The commentators are in disagreement on how this decision should be interpreted. On the one hand, this case fits easily within the literal approach. The notes involved were long-term notes and under the 1934 Act all long-term notes are securities. Therefore, according to the literal approach these notes were securities and this is exactly what the court held. On the other hand, the court clearly shied away from stating that all long-term notes are securities under the 1934 Act. The court refused to go any farther than to say that at the very least some long-term notes were securities and that the notes issued in this case were clearly within this category.

27. *See* Zabriskie v. Lewis, 507 F.2d 546 (10th Cir. 1974); Lino v. City Investing Co., 497 F.2d 689 (3d Cir. 1973); Exchange Nat'l Bank v. Touche Ross & Co., [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95614 (2d Cir. 1976).

28. *See* Lino v. City Investing Co., 487 F.2d 689 (3d Cir. 1973); United States v. Koenig, 388 F. Supp. 670 (S.D.N.Y. 1974); Joseph v. Norman's Health Club, Inc., 336 F. Supp. 307 (E.D. Mo. 1971).

29. 487 F.2d 689 (3d Cir. 1973).

a holding that the transaction did not involve a 'purchase' of securities."[30]

In *Lino* the court concluded that notes issued to facilitate commercial transactions were outside the securities laws. Other circuits, faced with the note-security issue have similarly utilized the "unless" language to avoid the literal meaning of the statute.[31] Three distinct tests have developed in lieu of the literal approach.[32]

Commercial-Investment Note Test

Of the three variations, the commercial-investment note test has proved the most popular.[33] This test distinguishes between investment and commercial transactions in determining whether the provisions of the 1933 or 1934 Act apply. Under this test, if a note is issued to facilitate a sale of goods then it is considered to be part of a commercial transaction and held not to be a security.[34] On the other hand, if there is no underlying sale then the note is being issued in return for money. If this money is used to finance a business scheme then the note is part of an investment transaction and is deemed a security.[35]

McClure v. First National Bank became the first appellate case to analyze long-term notes in relation to the commercial-investment note test.[36] *McClure* involved a bank loan to a

30. *Id.* at 694.

31. For a discussion of how the courts have misinterpreted the phrase "unless the context otherwise requires," see Hammett, *Any Promissory Note: The Obscene Security, A Search for the Non-Commercial Investment,* 7 TEX. TECH. L. REV. 25, 38-40 (1975).

32. One case in 1976 took the literal approach in defining the term security in the 1933 Act to include all promissory notes. However, this was a Georgia appellate case. *See* Peoples Bank of LaGrange v. North Carolina Nat'l Bank, [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95651 (Ga. App. 1976). Section 22 of the 1933 Act gives state courts concurrent jurisdiction.

33. *See, e.g.,* Zabriskie v. Lewis, 507 F.2d 546 (10th Cir. 1974); McClure v. First Nat'l Bank, 497 F.2d 490 (5th Cir. 1974); Lino v. City Investing Co., 487 F.2d 689 (3d Cir. 1973); Sanders v. John Nuveen & Co., 463 F.2d 1075 (7th Cir. 1972).

34. The American Law Institute's tentative draft of the Federal Securities Code includes not only a definition of "security" but also sets forth certain items which are not included in the term security. ALI FED. SECURITIES CODE § 297 (Apr. 1977 Draft). One exclusion is "a note or other evidence of indebtedness . . . issued in a mercantile . . . transaction." *Id.* § 297(b)(3). However a "mercantile transaction" is not defined. This has been the typical problem with the case law applying the commercial-investment note test; the courts just assume that the meaning of "commercial transaction" is clear. For a criticism of this test, see Exchange Nat'l Bank v. Touche Ross & Co., [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95614 (2d Cir. 1976).

35. *See* McClure v. First Nat'l Bank, 497 F.2d 490, 493 (5th Cir. 1974).

36. *Id.*

closely held corporation whose stock was owned by McClure and her ex-husband Hanslik. Hanslik and the defendant bank represented to McClure that the corporation needed to borrow money to pay off its debts.

Relying on the representations, McClure agreed to the execution of a long-term promissory note, which enabled the corporation to borrow the money. However, the money was not used to reduce the corporation's debts; instead the money was misappropriated by Hanslik, with the bank's knowledge, and used to reduce debts owed by Hanslik to the bank. McClure brought suit in federal court under the terms of the 1934 Act, alleging that the bank had used deceptive practices in purchasing the security. She contended that since the note was long-term, it was a security within the meaning of section 3(a)(10)[37] of the Act, bringing the transaction under its anti-fraud provisions.

The court viewed the long-term notes issued by the corporation as part of a commercial transaction. Although the literal approach would have categorized these notes, because of their long maturities, as securities under the 1934 Act, the court reasoned that Congress never intended the statute to extend to a purely commercial setting and held that notes issued in commercial transactions were not securities.

Cases like *McClure* distinguish between commercial and investment transactions when determining if the provisions of either securities act apply. Generally these cases find a transaction to be "commercial" if a note is issued to purchase some asset, or a note is issued to a bank for a loan, the proceeds of which are used as consideration for the purchase of a particular asset. A hypothetical tractor sale will serve to illustrate the parameters of a commercial transaction.

Commercial transactions. Agri-Corp., a large farming operation, buys a tractor from Harvast Day, a farm equipment retailer, by issuing a note.[38] Is this promissory note a security?

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37. 15 U.S.C. § 78c(a)(10) (1970).

38. *See generally,* C.N.S. Enterprises, Inc. v. G. & G. Enterprises, Inc., 508 F.2d 1354 (7th Cir. 1975); Lino v. City Investing Co., 487 F.2d 689 (3d Cir. 1973); Emisco Indus. Inc. v. Pro's Inc., [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95761 (7th Cir. 1976).

These three recent cases have applied the investment-commercial note test. The facts in these three cases are surprisingly similar. In all three cases the plaintiff had issued notes to the defendant in order to acquire an existing business or the assets of a business. In each case the plaintiff was alleging that the sale was induced by material omissions or material misstatements.

The note was issued by Agri-Corp. to obtain a capital asset, and it was accepted by Harvast Day in lieu of cash. The motive was to sell a tractor, not invest in Agri-Corp. This type of transaction would, therefore, be characterized by a court as commercial. The court would simply view Agri-Corp. as having issued the note to acquire a specific asset from Harvast Day and Harvast Day as accepting the note in order to make a sale of goods.[39]

What if we complicate the facts by including a bank loan in the transaction? Agri-Corp. issues a note to a bank for a loan. Agri-Corp. then takes the funds from the loan and buys a tractor.[40] Has Agri-Corp. created a security? This is a two-step transaction, but nothing has changed from our first example. The bank is merely acting as an intermediary. In this situation, a court applying the commercial-investment test would characterize the note according to the underlying transaction—the sale of the tractor—and reach the same result as in the first example. Thus, in the bank-note situation, one must look beyond the immediate transaction to the use of the proceeds to determine whether the note was issued to facilitate a sale.[41]

This analysis of the hypothetical tractor sale can be expanded and applied to a broader class of commercial dealings. Consequently, whenever an entity issues a note to purchase a

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In these cases, as in our tractor hypothetical, the note was issued in order to complete an underlying transaction. The underlying transaction in these three cases was the sale of a business. The note was being used as a medium of exchange, in lieu of cash, to consummate the sale. All three concluded that a note issued in such a situation was commercial and not a security.

39. *See* McClure v. First Nat'l Bank, 497 F.2d 490, 493 (5th Cir. 1974).

40. *See generally,* Great W. Bank & Trust v. Kotz, 532 F.2d 1252 (9th Cir. 1976);, McClure v. First Nat'l Bank, 497 F.2d 490 (5th Cir. 1974); Bellah v. First Nat'l Bank, 495 F.2d 1109 (5th Cir. 1974).

In these cases a business enterprise issued a note to a bank for a loan. In each case the facts were similar. The business was in need of financing to pay off existing debts coming due and to pay the expenses of operating the enterprise. The underlying transaction was a sale, although the relationship between the bank and the sale was attenuated. The courts concluded that the note was part of a commercial transaction and thus not a security.

In our tractor hypothetical the corporation issued a note to the bank in return for funds. The funds were then used to purchase the tractor. In the foregoing cases the purchaser of goods issued a note to the company selling the goods. The purchasing company then issued a second note to a bank, and with these funds paid off the note held by the selling company. Although there are more transactions involved, the result is the same.

41. If an underlying sale of goods was involved, McClure v. First Nat'l Bank, 497 F.2d 490, 493 (5th Cir. 1974), indicates that the note was issued in a commercial transaction.

product and the note is taken as consideration for the sale of the product, the transaction should not be characterized as involving a security. In such cases the note is being used as a medium of exchange to facilitate a sale; it is being issued in a commercial transaction. Similarly, if a bank loan is involved, and a note is being issued to the bank to effect an underlying sale of goods then the note is also part of a commercial transaction and is not a security.

Investment transactions. Courts making the investment-commercial distinction will generally find an "investment" transaction and the provisions of the Securities Act applicable when: a note is issued for cash, or a note is issued to a bank for a loan, and the proceeds are used to finance a business scheme, rather than acquire a particular asset.[42] The parame-

42. The majority of cases dealing with bank loans have held that the note issued in the loan situation is a commercial note and thus not a security. *See* Great W. Bank & Trust v. Kotz, 532 F.2d 1252 (9th Cir. 1976); McClure v. First Nat'l Bank, 497 F.2d 490 (5th Cir. 1974); Bellah v. First Nat'l Bank, 495 F.2d 1109 (5th Cir. 1974).

These three opinions may lead the unwary into believing that all notes issued for bank loans are commercial. Indeed Judge Wright, in his concurring opinion in *Kotz*, argued that when a note is issued to a bank in a commercial loan transaction the federal securities laws should not apply. Great W. Bank & Trust v. Kotz, 532 F.2d at 1260. Judge Wright presented three arguments for his position. First, he noted that the case law has uniformly held, with two exceptions, that commercial loan transactions are not securities. Second, he reasoned that commercial lending transactions are unrelated to the abuses which the 1933 and 1934 Acts sought to eliminate. Normally, an issuer of a security has access to and control of the information relevant to the investment decision. Since banks are normally in a position to force disclosure or to verify the maker's assertions, they do not generally need the protection of the securities laws. Finally, he concluded that Congress has distinguished between the investing and lending activities of a bank. The investment portfolio of a bank is limited to a distinct set of securities and it does not include notes issued to a bank in its commercial lending function. Judge Wright sought to extend the distinction between a bank's lending and investment functions to the security field. Since notes held by a bank are a result of the lending function they do not represent an investment transaction and are not securities.

A recent Second Circuit decision has explicitly rejected Judge Wright's position that all notes issued to a bank in commercial loan transactions are securities. *See* Exchange Nat'l Bank v. Touche Ross & Co., [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95614 (2d Cir. 1976). In addition, Judge Wright's conclusion that all notes issued to a bank are outside the securities laws seems to be too broad. Further, his rationale for distinguishing notes issued to banks from all other notes is unpersuasive. What is it about a note issued to a bank that characterizes it as a commercial note? It is difficult to support Wright's conclusion that a note issued to a bank is never a security.

Although one could argue that a bank is a sophisticated holder, that it is in somewhat less need of protection, and that it is generally a conservative lender and limits its risks, these facts do not indicate that a note held by a bank is per se commercial. However, these facts may indicate a bank's propensity to avoid investment notes. If this is the case, the best approach would be to recognize the probability that a note

ters of an investment transaction also can best be defined through the use of a hypothetical.

An individual or a business entity is approached by a promoter desiring to create a corporation to manufacture widgets. After some dealing, the parties reach an agreement and a note is issued by the promoter in exchange for cash to finance the corporate enterprise. Is this note a security? The note was not issued to acquire a tangible asset, although the money may eventually be used to acquire tangible assets. The holder of the note, likewise, did not accept the note to consummate a sale of goods. His motive is not present oriented—to make a sale—but future oriented—to gain a return on the money loaned. Under these circumstances, application of the commercial-investment test compels the conclusion that this is an investment transaction and that the note is therefore a security.[43]

What about a bank loan in such a situation? Suppose that instead of going to a financier to obtain funds for the widget business, the promoter goes to a bank loan officer and after some negotiations obtains the needed money by issuing the bank a note. Is this a security? There is no underlying sale of goods with which to characterize this bank loan as a commercial transaction. There is no way of knowing how the funds will be used by the corporate management to change the capital assets they purchase into a profitable manufacturing enterprise. The bank is essentially standing in the shoes of a typical

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issued to a bank will not be a security, yet continue to analyze the transaction in terms of one of the other tests.

43. *See generally,* SEC v. World Radio Mission, Inc., [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95751 (1st Cir. 1976); Zabriskie v. Lewis, 507 F.2d 546 (10th Cir. 1974); Sanders v. John Nuveen & Co., 463 F.2d 1075 (7th Cir. 1972). These cases involved the issuance of a note by the corporation to an individual in return for cash. In *Zabriskie* a real estate broker induced the plaintiff to provide money to promote a corporation in return for a promissory note. In *World Radio Mission,* the religious organization was issuing interest-bearing notes to investors to finance the building of a religious community. In *Sanders,* a broker was selling commercial paper to individuals.

All these transactions were similar. The notes were not being issued to obtain a capital asset and they were not accepted to consummate a sale. This was not a bank loan, where you must look for the primary transaction. This was the primary transaction, and the note was being issued in exchange for cash. The individual's motive in providing cash to finance the business was not present oriented—to make a sale; it was future oriented—to gain a return. The individual was clearly investing in the enterprise in the hope of making a profit. There is nothing in these cases which indicates that the holder of the note was entering into a commercial transaction. The transactions were profit motivated. Therefore, the notes should be characterized as investment instruments and thus securities.

investor who might lend money to a promoter. The transaction is to finance a business, to put funds into management's hands with which they hope to create profits.[44] Here courts again are likely to look at the underlying investment character of the transaction and determine that the note is a security.[45]

The Risk Test

In contrast to the commercial-investment distinction, the Ninth Circuit has opted for a risk test when analyzing whether a note is a security. Despite a different conceptual focus, the Ninth Circuit considers its test synonymous with the commercial-investment note test applied in most other circuits.[46] The risk test looks to whether the holder of the note has contributed capital to a business which is subject to the managerial and entrepreneurial whims of the issuer.[47] If the transaction involves this so-called "risk capital," and not simply a risky loan, then the court characterizes the note as a security.[48]

The Ninth Circuit articulated its approach to the note-security issue in *Great Western Bank & Trust v. Kotz.*[49] This case involved the issuance of a promissory note by Artco Corporation to Great Western in exchange for a line of credit. Artco later defaulted on the note and declared bankruptcy. Great Western then brought suit against Kotz, the president of Artco, seeking recovery of some of its losses.

The Ninth Circuit in *Great Western* set out five factors

44. Recent note-security cases, using the commercial-investment note test, have treated an investment transaction as synonymous with an investment contract. *See* Emisco Indus., Inc. v. Pro's, Inc., [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95761, at 90737 (7th Cir. 1976); SEC v. World Radio Mission, Inc., [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95751, at 90658 (1st Cir. 1976). United Housing Foundation, Inc. v. Forman, 421 U.S. 837, 852 (1975), defines an investment contract and then states: "The touchstone [of a security] is the presence of an investment in a common venture promised on a reasonable expection of profits to be derived from the entrepreneurial or managerial efforts of others."

45. *See* Exchange Nat'l Bank v. Touche Ross & Co., [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95614 (2d Cir. 1976).

46. *See* Great W. Bank & Trust v. Kotz, 532 F.2d 1252, 1257 (9th Cir. 1976).

47. The ultimate inquiry in the Ninth Circuit is whether risk capital has been contributed subject to the entrepreneurial or managerial efforts of another. *Id.* at 1257. This test is derived from a recent Supreme Court case defining investment contract. *See* note 44 *supra.*

48. Risk capital in its most recognizable form is money invested in a new enterprise as start-up or seed capital. "The thrust of the inquiry under the risk capital test is whether the investor has subjected his money to the risk of an enterprise over which he exercises no managerial control." R. JENNINGS & H. MARSH, SECURITIES REGULATION, 230 n.7 (4th ed. 1977).

49. 532 F.2d 1252 (9th Cir. 1976).

that play a key role in the determination of whether or not an investor has placed his capital at the risk of a particular business and therefore, whether or not a particular note will be classified as a security for purposes of the risk test.[50]

The first and most important factor is time. Although the 1934 Act's short-term (nine-month) exemption is no longer followed literally, the court recognized that most short-term notes are not securities unless repayment of the capital is dependent on the success of a risky venture. In this context time is crucial to the concept of risk because the longer funds are held and used by another, the greater the risk of loss.

The second factor is the existence of some type of collateral. The court focused on the worth of the collateral *vis-a-vis* the amount of capital loaned. The lower the ratio of the value of collateral to capital, the more dependent the lender is upon the managerial skills of the borrower or promoter.

A third factor affecting risk is the size of the business enterprise and its financial structure in relation to the amount borrowed. The Ninth Circuit viewed this as crucial, since it points to the ability of the borrower to repay.[51]

Whether the obligations were issued to a single person or a large number of investors is a fourth factor. Finally, there is the contemplated use of the proceeds.[52] Notes issued to obtain proceeds used in forming the enterprise are generally securities, while those used to maintain a current financial position are not.

After examining Great Western's transaction in light of these five factors, the Ninth Circuit concluded that the bank had not invested risk capital subject to the entrepreneurial efforts of Artco. As a result, the latter's note was not a security. As to the time element, the note was of short maturity (ten months) and could not be renewed without Great Western's consent. Thus, the money was not at risk for a great length of time.

With respect to collateral, although the note was unsecured, the loan agreement required Artco to maintain a large bank balance, tantamount to partial security, thereby reducing the risk of loss. Similarly, in regards to Artco's financial structures, the $1.5 million line of credit was not inordinately large,

50. 532 F.2d 1252, 1257 (9th Cir. 1976). The case does not distinguish between factors that affect risk of loss and factors which affect risk capital.

51. *Id.*

52. *Id.*

and the loan agreement further required it to keep $4 million in working capital on hand.

Finally, in relation to factors four and five, the loan agreement indicated that it was a standard commercial loan, individually negotiated so that it involved a single lender and not a pool of investors. It also required that the funds loaned be used only for working capital, thus helping Artco maintain its current financial position.

Not surprisingly, the Ninth Circuit is the main proponent of the risk-capital approach, since Justice Traynor of the California Supreme Court is commonly given credit for developing the concept in *Silver Hills Country Club v. Sobieski.*[53] California and the Ninth Circuit, however, are not the only proponents of the risk-capital approach. Several commentators in discussing the meaning of a security have relied on this approach in distinguishing transactions which fall inside the federal securities laws from those that do not.[54] While there is support for the risk approach, a recent Supreme Court case refrained from adopting it.[55]

The Second Circuit Test

In *Exchange National Bank v. Touche Ross & Co.,* the Second Circuit has recently offered a third alternative test that may be utilized in determining whether a note is a security.[56] Exchange National had purchased from Weiss Securities Incorporated, a member of the New York Stock Exchange, three unsecured subordinated notes with an aggregate principal amount of $1 million. After Weiss defaulted on the notes and went into receivership, Exchange National sued Touche Ross, Weiss' accountant, for fraud in its preparation and certification of the accuracy of Weiss' balance sheet.[57]

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53. 55 Cal. 2d 811, 361 P.2d 906, 13 Cal. Rptr. 186 (1961). *See* Hannan & Thomas, *The Importance of Economic Reality and Risk in Defining Federal Securities,* 25 HAST. L. REV. 219, 231-33 (1974).

54. *See* Coffey, *The Economic Realities of a "Security": Is There a More Meaningful Formula?,* 18 CASE W. RES. L. REV. 367 (1967); Long, *An Attempt to Return "Investment Contracts" to the Mainstream of Securities Regulation,* 24 OKLA. L. REV. 135 (1971).

55. United Housing Foundation, Inc. v. Forman, 421 U.S. 837, 852 n.16.

56. [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95614, at 90062-63 (2d Cir. 1976).

57. A motion to dismiss was made by Touche Ross on grounds that the complaint did not state a cause of action in fraud. This motion was denied. It was denied prior to the Supreme Court's decision in Ernst & Ernst v. Hochfelder 425 U.S. 185 (1976). The appeal by Touche Ross was from denial of a motion to dismiss because of lack of

In dealing with Exchange National's claim, the Second Circuit indicated its dissatisfaction with the commercial-investment note distinction because of the case law's inability to articulate the factors which underlie this test.[58] Therefore, the court concluded that it would henceforth follow a literal approach "unless the context otherwise required":

> A party asserting that a note of more than nine months maturity is not within the 1934 Act (or that a note with a maturity of nine months or less is within it) or that any note is not within the antifraud provisions of the 1933 Act has the burden of showing that "the context otherwise *requires.*"[59]

The court then proceeded to list six instances where "the context otherwise requires" and therefore, the notes issued would not be deemed a security. These included:

> [1] the note delivered in consumer financing, [2] the note secured by a mortgage on a home, [3] the short-term note secured by a lien on a small business or some of its assets, [4] the note evidencing a character loan to a bank customer, [5] short-term notes secured by an assignment of accounts receivable, or [6] a note that simply formalizes an open-account debt incurred in the ordinary course of business (particularly if as in the case of the customer of a broker, it is collateralized).[60]

During the course of its analysis, the Second Circuit rejected the commercial-investment note and risk-capital tests for what it considered a more rigid and predictable approach.[61] Yet, each of the six transactions described in *Exchange National* can probably be defined as either low risk or commercial.[62] Arguably then, notes issued in these types of transactions would also not be classified as securities under the risk-capital or commercial-investment note tests.

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subject matter jurisdiction—note was not a security and the court did not pass on the defenses which *Hochfelder* may make available to Touche Ross.

58. Exchange Nat'l Bank v. Touche Ross & Co., [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 85614, at 90062-63 (2d Cir. 1976).

59. *Id.* at 90063.

60. *Id.*

61. *Id.*

62. If a note is part of an investment transaction it is a security; if it is part of a commercial transaction it is not a security according to the investment-commercial note test. Since a note issued in one of the six special categories set out by the court is not a security, it would be viewed as a commercial note under the investment-commercial approach.

Three of the six categories set out in the case share the common nexus of being collateralized transactions.[63] The court's emphasis on collateral seems to be an unarticulated attempt to limit the risk involved in the transaction. In requiring collateral, rather than emphasizing risk, the court has achieved a degree of certainty not present in the risk test. Similarly, the character loan to a bank customer, although not collateralized in the formal sense, is secured by the individual's good name and the bank's past experience with this person. This would seem to be a low risk transaction and inherently lacking in investment motive. Further, the motive underlying a consumer credit transaction is not one of investment but one of consumption, personal use, or enjoyment.[64] Therefore, a note issued under these circumstances would clearly be commercial.[65]

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63. These are the note secured by a mortgage on a home, the short-term note secured by a lien on the business or some of its assets, and the short-term note secured by an assignment of accounts receivable. Two of these categories refer to short-term notes. The court does not make clear if "short-term" means 0-9 month notes, which will mature within a few years, or notes with a 20 year maturity.

64. For a definition of a consumer transaction, see 15 U.S.C. § 1602(h) (1970); U.C.C. § 9-109(1).

65. In general the cases have held that a note issued in a consumer transaction is not a security. United Housing Foundation Inc. v. Forman, 421 U.S. 837, 853 n.17 (1975); Lipton & Katz, *Notes are Not Always Securities*, 30 BUS. LAW. 763, 766-67, 768-69 (1975); Comment, *Commercial Notes & Definitions of Security Under Securities Exchange Act of 1934: A Note is a Note is a Note?*, 52 NEB. L. REV. 478, 510-11 (1973).

The Supreme Court in United Housing Foundation, Inc. v. Forman, 44 U.S. 837 (1975), held that "when a purchaser is motivated by a desire to use or consume the item purchased . . . the securities laws do not apply." *Id.* at 853. This clearly seems to be the right approach, for where a note has been issued in the consumer context there is no investment motive and thus no security.

The problem immediately arises in distinguishing between consumer and non-consumer transactions. This is the same problem which plagues the investment-commercial note distinction, however, finding an adequate definition of consumer is not nearly as hard as defining investment. The Truth In Lending Act defines consumer as follows:

> The adjective "consumer", used with reference to a credit transaction, characterizes the transaction as one in which the party to whom credit is offered or extended is a natural person, and the money, property, or services which are the subject of the transaction are primarily for personal, family, household, or agricultural purposes.

15 U.S.C. § 1602(h) (1970); *see* U.C.C. § 9-109(1).

Joseph v. Norman's Health Club, Inc., 366 F. Supp. 307 (E.D. Mo. 1971) is a good example of a note issued in a consumer transaction. Here the plaintiffs purchased lifetime memberships in a health club. To pay for the membership each plaintiff executed a promissory note. The promissory notes were quickly discounted to a local finance company at a substantial markdown. The plaintiffs asserted that the Club's failure to inform them of the cash price was a material omission. The courts held that the notes were not securities. This appears to be the right result, because the notes issued seem to fit into our definition of consumer transaction. First, the notes were

Finally, there is the note formalizing an open-account debt. This type of note would, more than any other, fit within the commercial transaction category. For example, suppose ABC Building Company has purchased cement from Portland Concrete Corporation on credit. Because it is unable to pay immediately, it formalizes the obligation by issuing a note. Such a note clearly arises out of commercial activity. The note is not issued or accepted with any investment motive but merely to formalize a sale and to evidence an already existing obligation.

It is suggested that the Second Circuit in *Exchange National* has drawn from both the commercial-investment note test and the risk-capital test in selecting its six categories of non-security notes. This court, however, has failed to present any reasons for treating these six categories specially. In fact, one cannot help feeling that if this test is applied in the future, new categories will be added on a case-by-case basis. Thus, the Second Circuit has seemingly fallen victim to its criticism of the other tests—the court has failed to give clear, substantive criteria that aid in determining when a note is a security.

THE PREFERRED APPROACH

In *United Housing Foundation v. Forman,* the United States Supreme Court rejected the literal approach traditionally used in determining whether an instrument issued in a particular transaction is a security.[66] The issue in *Forman* concerned whether or not shares of stock, which entitled the pur-

issued by natural persons and they were accepted by the company. Thus, credit was extended to a natural person. Second, the notes were issued to purchase membership in a health club. Clearly the services purchased with this credit were for personal purposes.

The definition used in the Truth In Lending Act differs from the Supreme Court's holding in *Forman* in two respects. First, the *Forman* holding does not restrict its definition to natural persons. *Id.* at 852-53. Under a broad reading of the case one might argue that corporations could be consumers, but this is probably not what the Court had in mind in defining a consumer transaction. The Truth In Lending Act is probably closer to the Court's intent in restricting the definition to natural persons. Second, the *Forman* Court also restricts its holding to the purely consumer setting. *Id.* at 853 n.17. It refuses to decide whether or not a transaction entered into partially for use and partially for profit would be exempt from the securities laws. The Truth In Lending Act's definition of consumer transaction would exempt a note from the securities laws if it was issued primarily for personal purposes. This seems to go a little farther than the Supreme Court holding. It seems reasonable to hold, however, that the note is a consumer instrument if the issuer can prove that his predominant reason for issuing the note was for personal use.

66. 421 U.S. 837 (1975).

chasers to lease an apartment in state subsidized and supervised nonprofit housing, were "securities" within the ambit of the 1933 or 1934 Act.

Both Acts include the term stock within the definition of a security,[67] yet the Court rejected the literal reading of the statutes and instead analyzed the underlying transaction to determine whether a security was involved. Thus, the opinion establishes that the name attached to an instrument, whether stock or note, is not determinative of its characterization as a security. Instead, the instrument and the transaction must be analyzed together to determine if a security is involved.

The Court went on to define the essence of a security: "The touchstone [of a security] is the presence of an investment in a common venture premised on the reasonable expectations of profits to be derived from the entrepreneurial efforts of others."[68] This language has since been relied on in a number of recent cases, applying the commercial-investment note test, to define an investment transaction.[69]

The analysis in *Forman* is important in two respects. First, by looking to the character of the underlying transaction, it indicates that the circuits were correct in their rejection of the literal approach. Second, by emphasizing the investment contract aspect of a security, it supports the assertion that the commercial-investment note test is the correct approach to be used when determining if a note is a security. Since there are basically four recurring fact patterns in the cases discussing the note-security issue, it becomes important, in light of *Forman,* to attempt to determine how they are likely to be resolved under the commercial-investment note test. Before examining these fact patterns, the definitions of commercial and investment notes should be recalled.

A commercial note is issued to finance an underlying sale of goods; it is used as a medium of exchange in lieu of money. An investment note, on the other hand, evidences an investment of money in a common enterprise with the expectation of profits to come from the efforts of others.

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67. Securities Exchange Act of 1934, § 3(a)(10), 15 U.S.C. § 78c(a)(10) (1970).

68. 421 U.S. at 852.

69. The *Forman* case involved an investment contract as distinct from an investment note. United Housing Foundation v. Forman, 421 U.S. 837, 852 (1975). Several recent cases have considered the investment contract test to be analogous to the investment note test. SEC v. World Radio Mission, Inc., [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95751 (1st Cir. 1976); Emisco Indus. Inc. v. Pro's Inc., [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95761 (7th Cir. 1976).

Purchasing a Business Entity

The first note-security fact pattern involves the buying of a going business. For example, suppose Mr. B negotiates the purchase of an athletic equipment business from Mr. S, by paying part of the price in cash and issuing a promissory note for the rest.[70] If Mr. B had merely bought the inventory for the sports shop from Mr. S the transaction would be commercial because the note would be issued in lieu of cash to facilitate a sale of goods.[71] There are a number of differences between buying a business and buying goods, the most important being management. In purchasing goods, there is only a profit potential if the buyer applies time, labor and skill. A business, however, is a self contained profit producing entity, and earnings are possible without the efforts of the buyer.

Although there are differences between buying goods and buying a business, almost all of the cases faced with this issue have concluded that the notes issued were not securities.[72] This appears to be the correct approach. There is an underlying sale which indicates that the notes are being issued as a medium of exchange. Also the seller of the business, Mr. S, cannot be said to be investing money (the business) in a common enterprise, since the seller's motive is to sell the business and not to invest it in a money-making scheme. These two facts indicate that a note issued to buy a business is generally a commercial note.

Investing Venture Capital

A second fact pattern concerns cases where the issuer of a note has solicited venture capital with which to start a business, develop land, or expand an enterprise into a new area.[73] This type of transaction is not a commercial one; there is no

70. There are a number of note-security cases in which a note was issued to purchase a going business. Emisco Indus., Inc. v. Pro's Inc. [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95761 (7th Cir. 1976) (Emisco purchased division of Pro's with note; note not a security); C.N.S. Enterprises, Inc. v. G. & G. Enterprises, Inc., 508 F.2d 1354 (7th Cir. 1975) (C.N.S. bought business from G. & G.; note not a security); Lino v. City Investing Co., 487 F.2d 689 (3d Cir. 1973) (note issued to buy two franchises held not a security). *Contra,* Movielab v. Berkey Photo, Inc., 452 F.2d 662 (2d Cir. 1971) (note issued to buy business held to be security).

71. *See* text accompanying note 41 *supra.*

72. *See* note 70 *supra.*

73. *See* Exchange Nat'l Bank v. Touche Ross & Co., [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95614 (2d Cir. 1976); Zabriskie v. Lewis, 507 F.2d 546 (10th Cir. 1974); Sanders v. John Nuveen & Co., 463 F.2d 1075 (7th Cir. 1972).

underlying sale of goods, and money is being invested in the business entity by a number of persons with the profits dependent on the managerial skills of the business entity. This fact pattern fits easily into the investment transaction and the courts have uniformly held that this is an investment transaction involving a security.

A more difficult fact situation to reconcile with the existing case law is where a business entity is issuing notes to investors but the proceeds received are to be used solely to meet current operational needs.[74] Despite the conceptual difference, the previous analysis should produce the same result. Whether the funds are used to expand or maintain a business is irrelevant, since the investors in both cases have placed money in a common enterprise with profits to come from the efforts of another.

Bank Loans to Businesses

A large number of cases have involved bank loans to corporations to meet current operational needs.[75] These cases have generally held that the note representing the loan transaction is not a security. Conceptually, this fact pattern presents the most difficulties. There is no underlying sale of goods, so it does not seem to involve a commercial transaction. Further, there is an investment of money with the expectation of profits to come from the efforts of others. This fact pattern appears to involve an investment transaction, yet the cases have held to the contrary.[76]

One possible explanation for this phenomenon is that the bank is a solitary investor. An investment contract requires a common enterprise and some of the circuits have read this to require a pool of investors.[77] Under this rationale, a note issued to a single investor, whether an individual or a bank, could not be a security. Whether or not this explanation is satisfactory,

74. This fact situation is difficult because bank loans in this situation are generally not considered to be securities. *See* note 75 *infra*.

75. *See* Great W. Bank & Trust v. Kotz, 532 F.2d 1252 (9th Cir. 1976); McClure v. First Nat'l Bank, 497 F.2d 490 (5th Cir. 1974); Bellah v. First Nat'l Bank, 495 F.2d 1109 (5th Cir. 1974).

76. *See* cases cited note 75 *supra*.

77. The second element in the investment contract test is the requirement that the investment be in a common enterprise. SEC v. W. J. Howey Co., 328 U.S. 293, 301 (1946). The conservative view, espoused in Milnarik v. M-S Commodities, Inc., 457 F.2d 274 (7th Cir. 1972), is that there must be a pooling of funds, through contribution by a number of contributors to a common promoter with a sharing of profits.

the case law clearly stands for the principle that bank loans to a corporation to help finance current operational requirements do not give rise to a security.

Consumer Transactions

In regards to the final fact pattern, the courts are in general agreement that notes issued in consumer transactions are not securities.[78] The *Forman* Court, for example, explicitly stated that consumer notes are not securities.[79] The rationale behind these decisions seems to be that the motive for accepting a note in a sale of consumer goods is not one of investment, but to facilitate the sale itself. These types of transactions, therefore, clearly fall into the commercial category.

CONCLUSION

As indicated above, the note-security cases have generally fallen into four fact patterns. With the demise of the literal approach, various circuits have responded differently to these patterns giving rise to three discernable tests for determining when a note issued in a particular transaction is a security.

The Second Circuit applies the literal approach unless the note falls into one of the special categories that make it a non-security.[80] No explanation was given for the existence of the special categories, and the court did not say if the six transactions listed were exclusive. The court did place the burden of proof on the party asserting that the statute should not be literally applied. However, the court did not decide what must be shown to meet this burden. Therefore in future cases, the Second Circuit will have to grapple with the nexus between the six categories it listed as exceptions, in order to apply the test consistently. At present, this is the most unworkable test because it offers no rationale for its exceptions.

The Ninth Circuit has opted for a risk analysis,[81] a test which is also unworkable. The court provides a list of factors which are to be weighed in deciding if a note is a security but it does not precisely define at what level of risk a non-security is converted into a security. Similarly, the risk test does not

78. *See* note 65 *supra.*

79. 421 U.S. at 852-53.

80. *See* Exchange Nat'l Bank v. Touche Ross & Co., [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95614, at 90063 (2d Cir. 1976).

81. *See* Great W. Bank & Trust v. Kotz, 532 F.2d 1252 (9th Cir. 1976).

adequately deal with notes issued in consumer sales. A note issued in a consumer sale can involve a high risk of default, pointing towards its classification as a security under this approach. Yet, courts have universally held that notes issued in consumer transactions are not securities.[82]

The majority of circuits apply the commercial-investment note test. It attempts to distinguish between investment and commercial transactions. This test has also been severely criticized.[83] Some commentators have accused the courts applying this test of using a case-by-case approach and failing to articulate the characteristics of commercial and investment notes.[84] This criticism is unjustified. A study of the case law applying this test indicates that commercial transactions involve an underlying sale of goods while investment transactions involve the issuing of a note in return for cash, where the money is to be used in a common enterprise with repayment and profits to come from the efforts of others.[85] This test seems to closely parallel the Supreme Court's investment contract test outlined in *Forman* and the Supreme Court, in dicta, has cited commercial-investment note cases with approval.[86]

On balance, the commercial-investment note approach appears to be the most workable. A court confronted with a note-security issue must scrutinize the underlying transaction and determine whether it falls into either the commercial or investment category. As previously noted, the parameters of both these categories have been well defined in the case law. Therefore, courts utilizing this approach are not forced to grapple with potential exceptions or weigh a level of risk, lending a consistency of interpretation to the note-security issue.

J. Casey McGlynn

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82. *See* note 72 *supra.*

83. *See* Exchange Nat'l Bank v. Touche Ross & Co., [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95614 (2d Cir. 1976); Hammet, *Any Promissory Note: The Obscene Security A Search for the Non-Commercial Investment,* 7 TEX. TECH. L. REV. 25 (1975).

84. *See* Pollack, *Notes Issued in Syndicated Loans—A New Test to Define Securities,* 32 BUS. LAW. 537, 541-42 (1977).

85. The note-security cases after *Forman* have treated an investment transaction as synonymous with an investment contract. See United Housing Foundation, Inc. v. Forman, 421 U.S. 837, 852 (1975); Emisco Indus., Inc. v. Pro's, Inc., [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95761, at 90737 (7th Cir. 1976); SEC v. World Radio Mission, Inc., [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95751, at 90658 (1st Cir. 1976).

86. 421 U.S. at 853 n.17.